No. 13284

United States
COURT OF APPEALS
For The Ninth Circuit

MUTUAL TELEPHONE COMPANY,
a Corporation,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

OPENING BRIEF
For Mutual Telephone Company,
Appellant

Appeal from the United States District Court for the District of Hawaii

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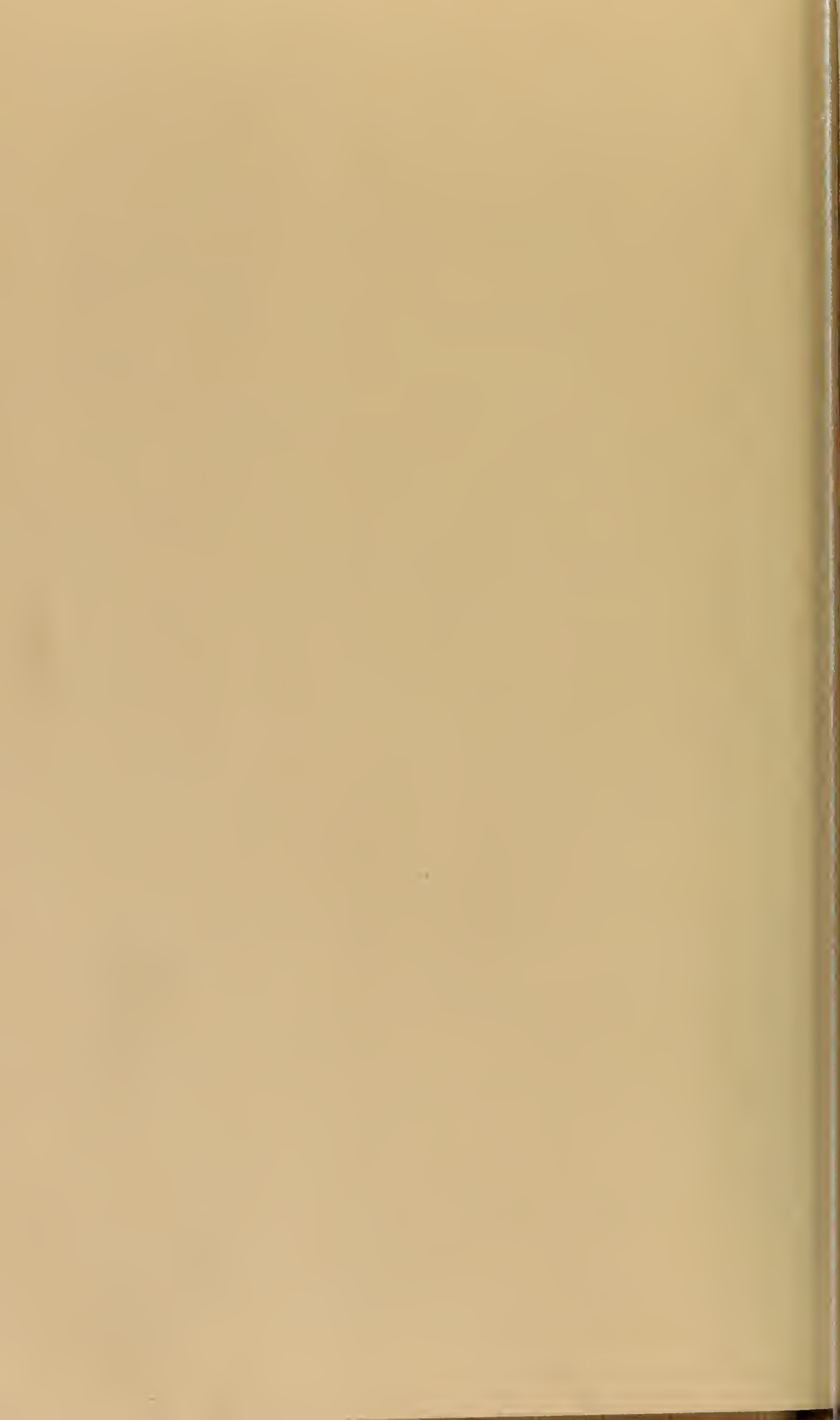
FILED
JUN 2 1952
PAUL P. O'BRIEN
CLERK



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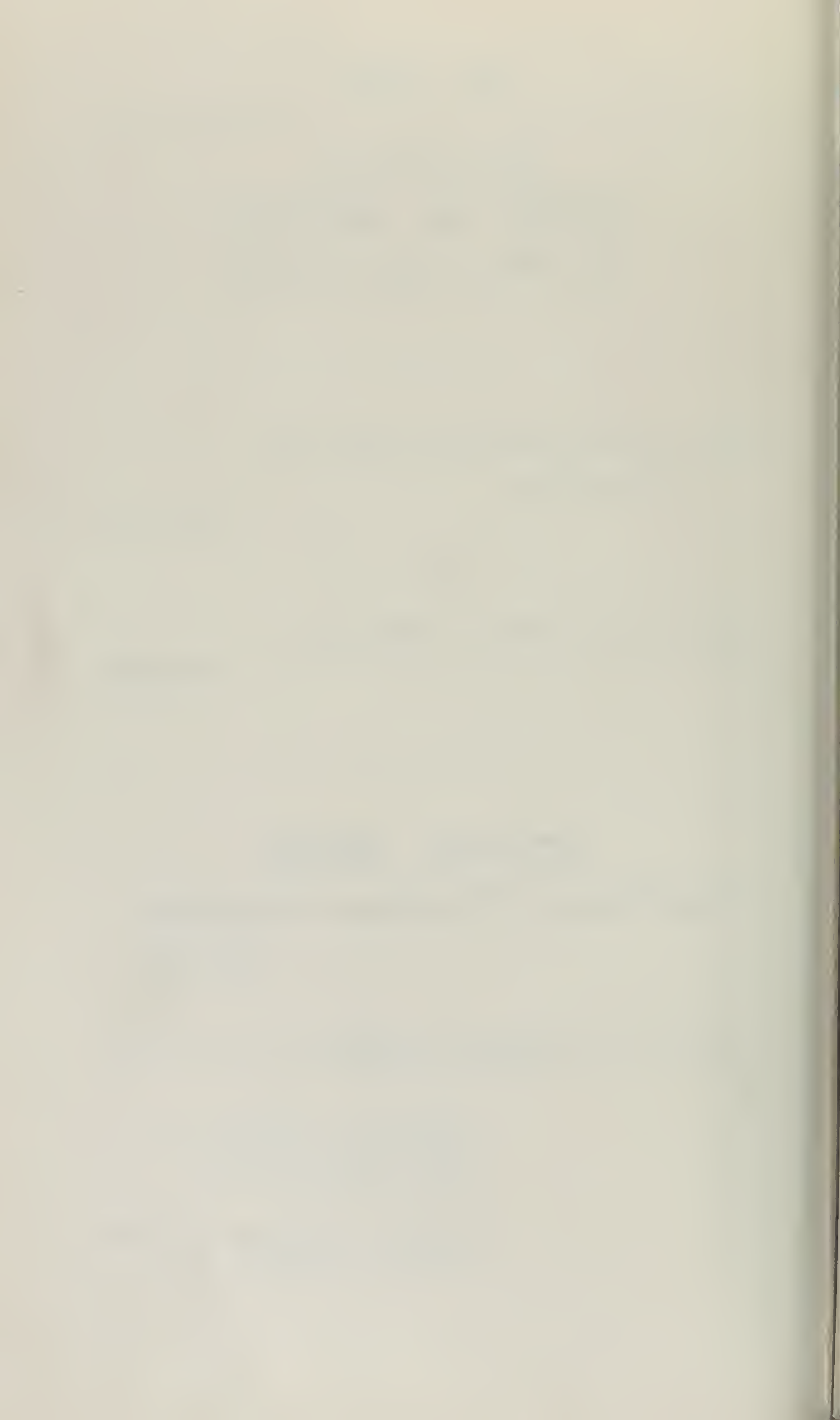

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JURISDICTION

This is a civil action commenced in the United States District Court for the District of Hawaii against the United States for recovery of internal revenue taxes alleged to have been erroneously and illegally assessed and collected. The claim exceeds $10,000 but the Collector of Internal Revenue by whom such tax was collected was dead and was not in office as Collector of Internal Revenue at the time this action was commenced. The District Court had jurisdiction of this action under Title 28, United States Code, Section 1346. Appellant has complied with the requirements of Section 3772(a)(1) and (2) of the Internal Revenue Code regarding suits for recovery of any internal revenue tax.

This court has jurisdiction to review the judgment below under Title 28, United States Code, Sections 41, 1291 and 1294.

The pleadings necessary to show the existence of jurisdiction are the Complaint (R. 3-11), the Second Amendment of Complaint (R. 11-14) and the Answer (R. 15-18). The Decision of the District Court (R. 83-99) was filed September 28, 1951 and the Judgment of the District Court (R. 100-101) was entered December 4, 1951. Appellant has filed a timely Notice of Appeal (R. 102), Bond for Costs on Appeal, Statement of Points on Appeal (District Court), Designation of Contents of Record on Appeal (District Court), and Statement of Points to be Relied Upon and Designation of Record to be Printed (Court of Appeals) (R. 102-106).

STATEMENT OF THE CASE

The question involved in this case is whether the increased "installation" and "supersedure" charges received by appellant from its subscribers in 1941 and 1942 were taxable income to appellant in those years. The Commissioner of Internal Revenue has determined that such installation and supersedure charges were taxable income to appellant in the years received. Appellant contends that such installation and supersedure charges were not taxable income to it in 1941 and 1942 because such charges were received and held in those years *subject to a restriction* and were *not* subject to appellant's "*unfettered command*". Appellant also contends, in the alternative, that such installation and supersedure charges are not taxable income to it in any year because such charges are not "*income*" within the meaning of the Sixteenth Amendment. The District Court held that such installation and supersedure charges were taxable income to appellant in the years received, that is, in 1941 and 1942.

All of the facts in the case have been stipulated.

Appellant is a public utility corporation existing under the laws of the Territory of Hawaii. Appellant's principal business consists of furnishing wire telephone service in the Hawaiian Islands. Appellant is subject to the jurisdiction of the Public Utilities Commission of the Territory of Hawaii, hereinafter sometimes referred to as "the Commission", under Chapter 82, Revised Laws of Hawaii 1945,

as amended (R. 19).[1] Its rates, fares, charges, classifications, rules and practices, and its form and method of keeping accounts, books and records, and its accounting system and its financial transactions are subject to the regulation of the Commission (R. 19).[2]

In 1941, due principally to the tremendous influx of war workers and military personnel and the expansion of the military establishment, appellant experienced an unusually large demand for new telephone service in Honolulu which placed an excessive load on its central office facilities and distribution plant (R. 33-34). At the same time priorities

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[1]The Territorial Public Utilities Act (now c. 82, R.L.H. 1945) was enacted in 1913, and by Act 135, Session Laws of Hawaii 1913 the legislature provided that all public utilities should be subject to the provisions of the Public Utilities Act effective upon the approval thereof by Congress. In 1916 Congress expressly ratified, approved and confirmed said Act 135 and thereby subjected to the Public Utilities Act all utilities doing business in Hawaii. *Inter-Island Co.* v. *Hawaii*, 305 U.S. 306, 310-312, 59 S. Ct. 202 (1938), *affirming* 96 F. 2d 412 (9th Cir., 1938) and 33 Haw. 890.

[2]Pertinent portions of said Chapter 82, Revised Laws of Hawaii 1945, as amended, are as follows:

Section 4715: "All rates, fares, charges, classifications, rules and practices made, charged or observed by any public utility, or by two or more public utilities jointly, shall be just and reasonable and shall be fixed by order of the commission, and no such rate, fare, charge, classification, rule or practice shall be abandoned, changed, modified or departed from without the prior approval of the commission. * * * * * * * * * * * * *

* * * The commission shall have power, after a hearing *upon its own motion, or upon complaint,*

and restrictions on materials and supplies made it difficult to meet the demands for new service (R. 34-35). Therefore, in order to *diminish the demand* for new telephone service, appellant in September, 1941 filed a petition with the Commission (R. 32-40) asking permission to increase its existing "installation" charges and to establish a new "supersedure" charge in the Honolulu exchange area. Installation charges (also known as "connection" charges) are of two types—service connection charges for connecting a telephone instrument newly placed in a subscriber's premises, and reconnection charges for reconnecting a dead telephone instrument already in place in a subscriber's premises. A supersedure charge is for substituting a new subscriber for a prior subscriber at the same premises, where the

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by order to regulate, fix and change all such rates, fares, charges, classifications, rules and practices, so that the same shall be just and reasonable, and to prohibit rebates and unreasonable discrimination between localities, or between users or consumers, under substantially similar conditions, to regulate the manner in which the property of every public utility is operated with reference to the safety and accommodation of the public, to prescribe its form and method of keeping accounts, books and records, and its accounting system, to regulate the return upon its public utility property, the incurring of indebtedness relating to its public utility business, and its financial transactions, and to do all things in addition which are necessary and in the exercise of such power and jurisdiction, all of which as so ordered, regulated, fixed and changed shall be just and reasonable, and such as shall provide a fair return on the property of the utility actually used or useful for public utility purposes." (Cont., p. 5)

telephone instrument is not dead and is not reconnected (R. 19-20). Appellant asked permission to increase its service connection charges from $3.50 to $15, $10, or $7.50 depending on the type of station, to increase its reconnection charges from $1.50 to $10, $7.50 or $5 depending on the type of station, and to establish new supersedure charges of $5 for a business station and $3.50 for a residence station (R. 37-38).

The Commission approved appellant's request in its Decision No. 51 (R. 40-47), and in its Order No. 379 (R. 48-52) authorized appellant to place the new charges in effect as of October 1, 1941. In its Decision the Commission stated:

> "The Company makes no showing that such an increase of revenue is required, and we believe it improper to allow the increase to go through in a manner that would permit the in-

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The italicized words in the second sentence "upon its own motion, or upon complaint" were stricken out by an amendment to this section in 1947 (1947 Session Laws, Series A-69); otherwise, the quoted portions of this section have been the same since 1933.

Section 4724: "Any public utility violating or neglecting or failing in any particular to conform to or comply with any of the provisions of this chapter or any lawful order of the commission shall forfeit to the Territory not more than one thousand dollars for every violation, neglect or failure, to be recovered by action brought in the name of the Territory by the commission, and may be enjoined by the circuit court from carrying on its business while such violation, neglect or failure continues."

This section has been the same since 1933.

crease to be passed on to the common stockholders in the form of increased dividends.

"* * *

"The increase over present charges would be credited to Account No. 175, Contributions to Telephone Plant, and in computing rates on an 'investment basis' would be a reduction from the net investment in arriving at a rate base. Investors would not require a return and subscribers would be spared paying a capital charge on same. On motion of the Commission or upon application of the Company, other disposition of the accrued balance might be made as conditions warranted.

"* * *

"The Commission in approving the increase and establishment of said charges, does not intend that such approval is to be construed as a finding of reasonableness of such charges or practices and is of the opinion that said charges should be but temporary, and that withdrawal of such approval should be made at such time as the Commission deemed appropriate." (R. 45-46).

In its Order the Commission provided:

"The amounts representing the increase in connection charges and charges for supersedure of service over and above those which are now being charged by petitioner in the same respective categories and the newly established charges for supersedure of service where no charge has been previously made, shall be charged to Account No. 175, Contributions to Telephone Plant, the amounts so accruing to be segregated from other charges to said account." (R. 51).

The increased installation and new supersedure charges were put into effect as of October 2, 1941 (R. 21). On April 22, 1942, appellant filed with the Commission a petition in which it requested that the increased charges be terminated because the U. S. Army Signal Corps had established a system of priorities for telephone allocations and the increased charges were no longer necessary for their retarding effect (R. 21, 53-57). This petition stated that appellant had credited the amount of monies received on account of such increased charges to a subaccount entitled "175.2—Liability for Installation Charges" and that appellant believed that it should be permitted to recapture this amount as income in installments spread equally over a five-year period beginning with 1942 (R. 56-57).

The Commission by its Decision No. 57 and Order No. 406 terminated the increased charges as of May 1, 1942 (R. 58-64). The Commission denied appellant's request to recapture the amount of the increased charges as income because this did not appear to be "the proper method by which this amount should be accounted for after giving consideration to the purposes for which these monies were obtained from subscribers" (R. 61). The Commission decided that the accrued balance in subaccount No. 175.2 should, until further orders of the Commission, be considered as "Contribution to Telephone Plant" and be treated as a reduction of the net investment in arriving at a rate base, provided that "upon motion of the Commission or upon application of the Com-

pany at some future date, other disposition of the accrued balance in said account No. 175.2 might be made as conditions warrant" (R. 61). In its order the Commission provided that the amount of money collected through the increased charges "shall be retained in Sub-account No. 175.2 'Contributions to Telephone Plant' and shall not be taken into the income account until such time as the Commission may authorize such action" (R. 64).

For many years appellant has kept its accounts in accordance with the Uniform System of Accounts for Class A Telephone Companies issued by the Federal Communications Commission, which system was prescribed for appellant by the Public Utilities Commission effective January 1, 1938 (R. 22). Account No. 175, "Contributions of Telephone Plant" is one of the accounts listed on the liability side of the balance sheet in the Uniform System of Accounts (R. 65-68). In accordance with the Uniform System of Accounts, appellant customarily credited to account No. 175 contributions by subscribers for line extensions; such contributions have never been reported as income for Federal tax purposes and have never been taxed as income (R. 23).

The increased installation and new supersedure charges were collected by appellant from subscribers from October 2, 1941 to May 1, 1942, and, pursuant to the Order of the Commission, appellant credited amounts equal to such collections to a new subaccount No. 175.2 entitled "Liability for Installation Charges" (R. 23). This new subaccount was started

by appellant and maintained as a subaccount under the general account No. 175 "Contributions of Telephone Plant" in order that the amounts in subaccount 175.2 could be segregated from the other amounts in account No. 175, in accordance with the Commission's order (R. 23).

In 1941 appellant received $13,341.50 on account of the increased installation and new supersedure charges, and in 1942 appellant received $28,673.00 on account of said charges (this total of $42,014.50 was subsequently adjusted to $41,970.50 to correct an accounting error of $44.00) (R. 24).

Appellant's billings to its subscribers did not show the amount of the increased installation charges separately from previously existing installation charges and did not show the newly-established supersedure charges separately (R. 24-25). However, appellant maintained its accounting records so as to reflect the amount of the newly-increased installation charges separately from the previously existing installation charges and so as to reflect the newly-established supersedure charges separately (R. 25). All of the additional charges were credited to subaccount 175.2 "Liability for Installation Charges" and appellant maintained a record of the amount of the additional installation or supersedure charge paid by each customer so that the exact amounts of such payments could be refunded to individual customers if this were ever required (R. 25). The monies collected by virtue of the additional charges were intermingled with other monies in the

general treasury of appellant, but appellant at all times material to this case had on hand cash or marketable securities in excess of the amounts collected from subscribers for the increased installation charges and new supersedure charges (R. 27).

Appellant maintains its records on the accrual basis and files its tax returns on the accrual basis for the calendar year. Appellant did not report the increased installation and supersedure charges received in 1941 and 1942 as part of its gross income in its tax returns for those years (R. 27). On November 2, 1943 the Internal Revenue Agent in Charge proposed deficiency assessments for 1941 and 1942 on the grounds of failure to include these charges in gross income. Appellant filed a protest with the Agent in Charge but the protest was denied and a determination of deficiency dated January 8, 1945 was sent to appellant. The deficiencies determined by the Commissioner of Internal Revenue on account of failure to include these charges in gross income were:

1941	Income Tax Liability		$ 1,978.47
	Excess Profits Tax Liability		6,959.35
1942	Declared Value Excess Profits Tax Liability		1,892.43
	Excess Profits Tax	$24,102.51	
	Less: 10% post war credit	2,410.25	21,692.26
Interest			4,205.88
	Total		$36,728.39

(R. 28).

Said additional taxes and interest in the total amount of $36,728.39 for both years were assessed and were paid by appellant on February 2, 1945 to

Fred H. Kanne, the then Collector of Internal Revenue for the District of Hawaii. Fred H. Kanne died prior to the time this action was commenced. Appellant filed claims for refund on December 6, 1946 for each year but the claims were disallowed by the Commissioner of Internal Revenue by notice of disallowance dated May 19, 1948 (R. 28-29).

During 1948 the Commission, following an application by appellant for an increase in rates, held a hearing on appellant's rates and charges (R. 29). Appellant did not suggest to the Commission at that time that any action be taken regarding subaccount 175.2, but the Commission on its own initiative as a part of its Decision No. 102 stated that the amount in this account should be transferred to appellant's "pension reserve"—meaning the "Retirement System of Mutual Telephone Company", a separate trust set up in 1931 to provide retirement benefits for appellant's employees (R. 29-31). Accordingly, the Commission's Order No. 598 entered August 7, 1948, provided that the amount of $41,970.50 carried in subaccount 175.2 be transferred by appellant to its "pension reserve" (R. 76-78). On December 3, 1948 appellant addressed a letter to the Commission outlining the tax difficulties that had arisen in connection with these additional charges and requested that the Commission suspend its order providing for the transfer of funds from subaccount 175.2. On December 22, 1948 the Commission replied that this matter should be held in abeyance by appellant pending formal

approval by the Commission. On February 24, 1949 the Commission advised appellant that it had denied appellant's request to suspend the transfer and ordered appellant to make the transfer in accordance with Order No. 598. On March 1, 1949 appellant deposited $41,970.50 in cash to the account of the "Retirement System of Mutual Telephone Company" in Bank of Hawaii (R. 31).

Thus, the question involved in this case is whether the increased installation and new supersedure charges were taxable income to appellant in 1941 and 1942, as contended by the Commissioner. Appellant contends first, that such charges were not taxable income to it in 1941 and 1942 because such charges were received and held in those years subject to a restriction and were not subject to appellant's "unfettered command".[3] Appellant also contends, in the alternative, that such charges are not taxable income to it in any year because such charges are not "income" within the meaning of the Sixteenth Amendment.

[3]Appellant and the Commissioner have signed a consent to the assessment of income taxes for the year 1948 at any time on or before June 30, 1953 (Form 872). The income tax to appellant will be less if the additional charges are income in 1948 or 1949 rather than in 1941 and 1942 because the excess profits tax was not in effect in 1948 or 1949.

SPECIFICATION OF ERRORS

1. The District Court erred in making its conclusion of law that the increased installation and supersedure charges received by appellant from its subscribers in the calendar years 1941 and 1942 constituted income ascribable to and taxable in those years (R. 99).

2. The District Court erred in rendering and entering its judgment dismissing the complaint in this action (R. 100-101).

3. The District Court erred in holding that appellant received the increased installation and supersedure charges "under a claim of right" (R. 97).

4. The District Court erred in failing to hold that the increased installation and supersedure charges were not income to appellant in 1941 and 1942 because such charges were received and held in those years subject to a restriction and were not subject to appellant's "unfettered command".

5. The District Court erred in failing to hold that the increased installation and supersedure charges are not includable in appellant's gross income for 1941 and 1942, or in any other year, because they do not constitute "income" within the meaning of the Sixteenth Amendment.

SUMMARY OF ARGUMENT

I. THE INCREASED INSTALLATION AND NEW SUPERSEDURE CHARGES RECEIVED BY APPELLANT FROM ITS SUBSCRIBERS IN 1941 AND 1942 WERE NOT TAXABLE INCOME TO IT IN THOSE YEARS BECAUSE SUCH CHARGES WERE RECEIVED AND HELD IN THOSE YEARS SUBJECT TO A RESTRICTION AND WERE NOT SUBJECT TO APPELLANT'S UNFETTERED COMMAND.

In *North American Oil Consolidated* v. *Burnet* 286 U.S. 417, 52 S. Ct. 613 (1932), the Supreme Court established the rule that "if a taxpayer receives earnings under a claim of right *and without restriction as to its disposition*, he has received income which he is required to return" (emphasis supplied). Similarly, in the earlier case of *Corliss* v. *Bowers*, 281 U.S. 376, 50 S. Ct. 336 (1930), the court said that "income that is subject to a man's *unfettered command* and that he is free to enjoy at his own option may be taxed to him as his income" (emphasis supplied). In the present case it is clear that the additional charges were received by appellant in 1941 and 1942 subject to the restriction imposed by the Commission that they were to be segregated and held in subaccount No. 175.2 and that they were not subject to appellant's "unfettered command" at that time—indeed, the Commission retained "unfettered command" over such additional charges until 1948. Furthermore, appellant did not receive such additional charges under a "claim of right" because it did not make any claim to retain them at the time it received them.

II. THE INCREASED INSTALLATION AND NEW SUPERSEDURE CHARGES ARE NOT TAXABLE INCOME TO APPELLANT IN 1941 AND 1942, OR IN ANY OTHER YEAR, BECAUSE THEY DO NOT CONSTITUTE "INCOME" WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

The additional charges were in the nature of contributions to appellant from its subscribers, which are similar to a governmental subsidy or donation or to contributions by customers to a utility for line or spur extensions, none of which are considered taxable income to the recipient. *Edwards* v. *Cuba Railroad*, 268 U.S. 628, 45 S. Ct. 614 (1925); *Liberty Light & Power Co.*, 4 B.T.A. 155 (1926) (Acq.); *Aransas Compress Co.*, 8 B.T.A. 155 (1927) (Acq.); *Great Northern Railway Co.*, 8 B.T.A. 225, 271 (1927) (Acq.) *aff'd.* 40 F. 2d 372; *Baltimore & Ohio Railroad Co.*, 30 B.T.A. 194, 199 (1934) (Acq.).

ARGUMENT

I. THE INCREASED INSTALLATION AND NEW SUPERSEDURE CHARGES RECEIVED BY APPELLANT FROM ITS SUBSCRIBERS IN 1941 AND 1942 WERE NOT TAXABLE INCOME TO IT IN THOSE YEARS BECAUSE SUCH CHARGES WERE RECEIVED AND HELD IN THOSE YEARS SUBJECT TO A RESTRICTION AND WERE NOT SUBJECT TO APPELLANT'S UNFETTERED COMMAND.

A. Governing Principles

The allocation of income to the proper year is a subject which has given rise to countless tax cases. Although no case has been found with the same facts as the case at bar, we believe that under the governing principles it is clear that the income[4] from the additional charges *cannot* be allocated to the years 1941 and 1942.

There should be no dispute about the governing principles. The rule is clearly stated in the often-quoted language of Mr. Justice Brandeis in *North American Oil Consolidated* v. *Burnet*, *supra*, at page 424:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the

[4]In this section of the argument it is assumed that the additional charges constitute taxable income to appellant in some year.

> money, and even though he may still be adjudged liable to restore its equivalent."

In this case the question was whether the sum of $171,000 received by the company in 1917 was taxable to it as income in that year. The company had operated a section of oil land which was claimed by the government and on February 2, 1916 the government had secured the appointment of a receiver to operate the property and hold the net income thereof. The $171,000 represented the net profits which had been earned from the property in 1916 during the receivership. In 1917 the District Court entered a final decree dismissing the government's appeal and the money was paid over by the receiver to the company. The government took an appeal to the Circuit Court of Appeals for the Ninth Circuit and in 1920 that court affirmed the decree; in 1922 a further appeal to the Supreme Court was dismissed by stipulation. The Supreme Court held that the profits were not taxable to the company in 1916, because the company was not required in 1916 to report as income an amount which it might never receive, but that profits became income to the company in 1917, when it first became entitled to them and when it actually received them.

The absence of a restriction on disposition as a test of taxable income is illustrated by the holding of Mr. Justice Holmes in the earlier case of *Corliss* v. *Bowers*, *supra*. In this case the court held that income from a revocable trust was taxable to the grantor and stated, at page 378:

> "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."[5]

The rule that the *absence* of a restriction on the disposition, use or enjoyment of property means that it is income has been reaffirmed many times. See *Brown* v. *Helvering*, 291 U.S. 193, 54 S. Ct. 356 (1934); *United States* v. *Lewis*, 340 U.S. 590, 71 S. Ct. 522 (1951). It is obvious from the mere statement of the rule that if there is a *restriction* there can be no income—if the Supreme Court had meant that mere receipt of money constitutes income, whether or not under a restriction, the recitation of the qualifying phrase is meaningless. See *Sohio Corporation* v. *Com'r*, 163 F. 2d 590, 593 (D.C. Cir., 1947).

Another statement of the same rule is made in the recent case of *Rutkin* v. *United States*, 342 U.S. 808,—S. Ct.—, 20 Law Week 4231 (1952), holding that money obtained by extortion is income taxable to the extortioner:

> "An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. *Burnet* v. *Wells*, 289 U.S. 670,

[5] "The 'use and enjoyment' of income is a vital fact * * *. See Corliss v. Bowers * * * where these factors were considered important as justifying a tax. The converse should be true." 2 Mertens, *Law of Federal Income Taxation*, p. 307 and n. 93.

> 678; *Corliss* v. *Bowers*, 281 U.S. 376, 378. That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it."

This court has recognized that sums required to be placed in a particular account or otherwise earmarked or restricted may not be income. *Baboquivari Cattle Co.* v. *Com'r*, 135 F. 2d 114 (9th Cir., 1943) involved payments by the United States to a ranching corporation in accordance with the Soil Conservation and Domestic Allotment Act. The company built reservoirs, dams, fences and similar improvements on its ranch and presumably complied with the range-improvement practices of the government. The company contended the payments were capital subsidies, not income, but this court held them income, stating:

> "No part of the sums paid to the petitioner were required to be placed by him in a particular account or fund. The payments were not earmarked, nor was there any restriction on their use. Petitioner was free to use the money for any purpose it might see fit, as to defray operating expenses or to pay dividends or to purchase an automobile." (116)

If the cattle company had been required by the government to segregate and hold its conservation payments in a particular account (as appellant was required to segregate and hold the additional instal-

lation and supersedure charges) it is apparent that this court would not have thought them income.

The general principles gained from these decisions are that earnings cannot be considered income unless: (1) the taxpayer receives the earnings under a claim of right *and* (2) the taxpayer receives the earnings without restriction as to their disposition, subject to his unfettered command, and with freedom to dispose of them at will.

It remains to apply these principles to the facts of the case at bar.

B. "Claim of Right"

In the first place, it is our contention that appellant did not receive the increased installation and new supersedure charges under a "claim of right" and that there is nothing in the record to support the District Court's holding that appellant did receive them under a claim of right (R. 97). In its petition to the Commission for authority to impose these charges, appellant did not assert that it required them as additional revenue or that it would be entitled to keep them (R. 36-39, 45-46). It wished the charges to be imposed in order to discourage demands for new telephone service in Honolulu. With respect to *disposition* of the amounts realized from the additional charges, appellant merely suggested in its petition that it be required to keep such amounts in a separate account, "the disposition of which may be determined at a later date" (R.

39), and the Commission's order so provided (R. 51). Appellant's feeling about its "right" to these charges is evidenced by its entry of them in an account which it entitled "Liability for Installation Charges" (R. 23) and by the manner in which it kept its records so that the additional charges could have been refunded exactly to the individual subscribers who paid them (R. 25). In its petition to terminate the additional charges in April 1942, appellant attempted *for the first time* to establish a "right" to them (R. 56-57), but this was rejected by the Commission (R. 60-61), which ordered that the additional charges should be retained in sub-account 175.2 (R. 64). Until the Commission's order of August 7, 1948 (R. 76-78) appellant did not know what would become of these additional charges, and it did not receive them under a "claim of right" in 1941 and 1942. The fact that the collection of the additional charges was authorized by the Commission does not mean that appellant claimed a "right" to them. In *Sohio Corporation* v. *Com'r, supra*, the taxpayer was authorized by state law to withhold from its vendors and retain a portion of the purchase price of oil bought from them (this was treated by the court as a "collection" of this amount from the purchasers—p. 591), but it was held that the amount withheld was not income to the taxpayer because not received under a "claim of right", the taxpayer having protested that the law was invalid.

C. Restriction on Disposition

Irrespective of whether appellant received the additional charges under a "claim of right", it is clear that it did not receive them "without restriction as to their disposition", subject to its "unfettered command", and with freedom to dispose of them at will. This second test of taxable income is *in addition to* the "claim of right" test and is equally important.[6]

Appellant is a utility subject to the jurisdiction of the Commission with respect to its rates and charges and its accounting system and is subject to a penalty of $1,000 and an injunction against carrying on its business for violating or neglecting or failing *in any particular* to conform to or comply with any lawful order of the Commission (n. 2, *supra*). The additional charges could not have been imposed in the first place without the order of the Commission, and the Commission certainly had the right to impose the restriction that they must be segregated and held in subaccount No. 175.2.[7]

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[6]"The Treasury and the lower courts have been inclined to forget the second qualification made by the Supreme Court. The income must not only be received under a claim of right, but it must be received *without restriction.* (North American Oil Consolidated v. Burnet)." I Montgomery's *Federal Taxes, Corporations and Partnerships*, 1951-52, 11.

[7]For a general discussion of the powers of federal and state public service commissions over the accounting practices of public utility corporations see I. R. Barnes, *The Economics of Public Utility Regulation*, Crofts, N.Y. 1942, where it is stated: "The control of utility accounts is one of the cornerstones

The Commission made it clear that the amounts in subaccount No. 175.2 could not be taken into appellant's income account or be passed on to its common stockholders as dividends (R. 45, 64). It should be pointed out, however, that the restriction was actually more severe than this—an amount equal to the additional charges collected must be segregated and credited to subaccount No. 175.2 and retained therein until further order of the Commission.

What did this mean as a practical matter? It meant that appellant could not actually obtain any benefit or use from the additional charges at all because it has to be prepared at any moment to pay out an amount in cash equal to the amount credited to subaccount 175.2 for any purpose the Commission might direct, just as in 1949 it had to deposit $41,970.50 in cash in Bank of Hawaii to the account of the Retirement System. The Commission might have directed that the charges be repaid to the subscribers who paid them or be turned over to the Commission or be applied for the benefit of the subscribers as a whole. If the Commission had held to its original intention it probably would have directed that the amount in subaccount No. 175.2 be retained permanently as a capital contribution and deducted

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on which the contemporary scheme of regulation is built." (p. 242) The broad powers of public service commissions over accounting are also indicated by *A. T. & T. Co.* v. *United States*, 299 U.S. 232, 57 S. Ct. 170 (1936) upholding the power of the Federal Communications Commission to prescribe a uniform system of accounts for telephone companies.

from appellant's net investment in plant (R. 46, 61)—in other words, this amount would be treated exactly as subscribers' contributions for line extensions and would never have been taxed to appellant as income at all (R. 23); *Edwards* v. *Cuba Railroad, supra; Liberty Light & Power Co., supra*, and other cases cited in the second section of this argument.

At the time it received the additional charges, appellant had no reason to expect it would be allowed to retain them itself. Appellant had conceded and the Commission had expressly found that appellant was not entitled to the additional charges as an increase in revenue (R. 45-46), and the Commission provided that its approval of the charges was not to be construed as a finding of their reasonableness (R. 46). A utility is not entitled to earn from the public more than a reasonable rate of return (Sec. 4715, R.L.H. 1945, n.2, *supra*), and appellant could hardly have resisted an order of the Commission to repay the additional charges when it could establish no right to them in the first place as necessary to enable it to earn a fair return on its public utility property within the meaning of the statute (Section 4715, *supra*, provides that a utility shall charge rates which are "just and reasonable" and shall be entitled to earn a "fair return" on its utility property). At the time of its application to terminate the additional charges in April, 1942 appellant attempted to "recapture" them as income, but this was rejected by the Commission (R. 56-57, 60-61).

Until 1948 appellant had no command whatever, fettered or unfettered, over the amounts in subaccount 175.2 and held them subject to complete restrictions as to their use, disposition and enjoyment. In effect, the Commission had impounded the $41,970.50, in the custody of appellant, until 1948 and itself retained "unfettered command" of these amounts until that time. Certainly appellant was not in 1941 and 1942 free to enjoy these amounts at its own option (*Corliss* v. *Bowers*, *supra*) or free to dispose of them at will (*Rutkin* v. *United States*, *supra*). As a "practical matter" appellant derived no "readily recognizable economic value" (*Rutkin* v. *United States, supra*) from the additional charges until 1948 or 1949.

The restriction imposed by the Commission was not merely one of the "niceties of accounting technique" or part of the "jargon of bookkeeping" as the District Court seemed to believe (R. 97). During the period prior to August 7, 1948, appellant could have made no more use of the $41,970.50 than if it had been placed in escrow or locked up in a bank subject to the Commission's order. True, appellant received the actual physical currency and mingled it with its other receipts and used all of its currency without regard to source, but at the same time it always had to have on hand an equivalent amount of cash or marketable securities which could be paid out as the Commission ordered.[8] Appellant could not have

[8]The stipulation of facts states that appellant "at all times material herein had on hand cash or marketable securities in excess of the amounts collected from subscribers for the increased installation charges and new supersedure charges" (R. 27).

"borrowed" from the fund without substituting an equivalent amount of marketable securities. If appellant had failed to keep on hand cash (or assets readily convertible into cash) sufficient to cover the amount entered in subaccount 175.2 it would have been in violation of the Commission's order. The Commission's purpose obviously was to require appellant to segregate the amount of the additional charges in a liability or suspense account so that money equal to this amount could be paid out by appellant at any time for any purpose the Commission saw fit to direct. Under these circumstances, the possession and use of the physical currency was of no significance to appellant.

D. Intermingling of Funds

It would be unduly technical and would exhalt form above substance to make the result in this case depend upon the segregation of the physical currency. Suppose, for example, that appellant had cashed each subscriber's check, taken currency equal to the amount of the additional charges, and placed that currency in a safe in the office of the Commission. Perhaps the Commission could have made such a requirement, but with a responsible public utility company it would have been absurd to do so. The Commission achieved the same result by ordering appellant to segregate and hold the charges in subaccount 175.2, and appellant received in 1941 and 1942 no more and no less benefit from the charges

than it would have received if the currency had been placed in a safe in the Commission's office.

The principle that the substance of a transaction rather than its mere form controls the determination of tax liability is too well-established to require much comment.[9] In several recent cases involving the receipt of monies which the taxpayer was not necessarily entitled to keep, the tax court has held that the fact that such monies were intermingled without distinction with the other funds of the taxpayer and were used without regard to their source did not make such monies "income"—in other words, the fact of intermingling or use of the physical currency by the taxpayer is immaterial. *Seven-Up Co.*, 14 T.C. 965 (1950) (Acq.); *Broadcast Measurement Bureau, Inc.*, 16 T.C. 988 (1951) (Acq.); *Bates Motor Transport Lines, Inc.*, 17 T.C. No. 18 (1951) (Acq.). The Commissioner of Internal Revenue has acquiesced in each of these decisions.

The fact that segregation on the books of the taxpayer rather than physical segregation of the money or deposit of the same with a third party is sufficient to keep the segregated sums out of income is illustrated by the title insurance company "unearned premium" cases. *Early* v. *Lawyers Title Ins. Corporation*, 132 F. 2d 42 (4th Cir., 1942), deals

[9]"The incidence of taxation depends upon the substance of a transaction", *Comm'r* v. *Court Holding Co.*, 324 U.S. 331, 334, 65 S. Ct. 707 (1945); I Montgomery's *Federal Taxes, Corporations and Partnerships*, 1951-52, 322.

with a Virginia corporation required by state law to set up 10% of its original title insurance premiums as a reserve for unearned premiums. There was no requirement of segregating the physical monies or placing the money in the hands of a third party. It was only necessary for the title insurance company to establish a reserve on its books. The court held that the amount of the reserve should be treated as unearned premiums and need not be included in taxable income until released from the reserve.

> "The passage of the Virginia statute [requiring segregation of the unearned premium reserve] unquestionably resulted in funds to the amount of the reserve at the end of the year being withdrawn from the unfettered control of the company and being held in trust for the benefit of contract holders; and the practical effect of this was to decrease by such amount the income of the year available for ordinary purposes." (p. 46)

A similar case is *Title & Trust Co.*, 15 T.C. 510 (1950), recently affirmed by this court *per curiam* in 192 F. 2d 934 (9th Cir., 1951). Complying with the directive of the Oregon Insurance Commissioner issued pursuant to the Oregon statute, the taxpayer segregated from its 1945 premium income an amount equal to 3% of its total premiums in 1942-1945 as an unearned premium reserve. The tax court held that the taxpayer properly excluded this reserve from its 1945 premium income. It is obvious from a statement of the facts that the taxpayer did not

physically segregate the monies but merely set up on its books an account captioned "unearned premiums". The tax court held that in effect that by the action of the taxpayer taken pursuant to the directive of the Insurance Commissioner, the reserve was taken from income and thus made "unavailable to the company for general corporate uses" (p. 516-517).

In the cases referred to in paragraphs 2, 4, 5, 6, 7, 8 and 9 (*Portland Cremation Ass'n, infra*) of Section F, below, the physical funds were in the possession and control of the taxpayer and mingled with his other monies and were or could have been used by the taxpayer without regard to their source, but because of various restrictions were held not to be income in the year of receipt.

All of these authorities show that the fact of intermingling of the additional charges with the other monies in appellant's general treasury is immaterial in determining whether the additional charges were income to appellant in 1941 and 1942.

E. Obligation to Repay

We recognize that the contingent obligation of appellant to *repay* the additional charges would not be sufficient to keep them out of income in the year received under the decision in *North American Oil Consolidated* v. *Burnet, supra,* and cases following it.[10] The distinction is that the taxpayer in those

[10]For instance, *Comm'r* v. *Alamitos Land Co.*, 112 F. 2d 648 (9th Cir., 1940), *cert. denied* 311 U.S. 679, where the court found that the taxpayer had "absolute dominion" over the fund received under a judgment entered in 1932 which was subsequently appealed and reversed.

cases received the money and during the period before the ownership was finally determined could do with it absolutely as it pleased. The money could have been passed on to its stockholders in the form of dividends (North American Oil Consolidated entered the earnings from the property in 1916 on its books as "income"—286 U.S. 421) or used for any other purpose, just like all of its other income. Appellant, on the other hand, could not and did not take the $41,970.50 into its income account (R. 64, 23)—this amount did not go to swell the surplus from which dividends could be declared and did not become part of ordinary income which could be used for general corporate purposes. The amount was entered and held in a liability or suspense account under the order of the regulatory commission (R. 23), which meant that an equal amount of cash or marketable securities had to be kept on hand at all times to be paid out under the direction of the Commission. Neither the stockholders nor the company had any economic benefit from these additional charges in 1941 and 1942, and might never have had any economic benefit therefrom if the Commission had not ordered the transfer of the funds out of subaccount 175.2 in 1948.

F. Cases Illustrative of Receipts under a Restriction

Although no case has been found with facts the same as the case at bar, the following cases are illus-

trative of the rule that funds received subject to a restriction as to their use or disposition or not subject to the "unfettered command" of the recipient do not constitute income when received:

1. Payments received or impounded in escrow or in court or in a bank account are not required to be included in taxable income until released from custody, even though the payments have already been earned. *McLaughlin* v. *Comm'r*, 113 F. 2d 611 (7th Cir., 1940); *London-Butte Gold M. Co.* v. *Comm'r*, 116 F. 2d 478 (10th Cir., 1940); *Leedy-Glover Realty & Insurance Co.*, 13 T.C. 95 (1949) (Acq.); *Estate of Dick W. Paul*, 11 T.C. 148 (1948) (Acq.); *Merton E. Farr*, 11 T.C. 552 (1948) (Acq.), *aff'd* 188 F. 2d 254 (6th Cir., 1951); *Estate of Margaret McAllen Fairbanks*, 3 T.C. 260 (1944) (Acq.); *E. P. Madigan*, 43 B.T.A. 549 (1941) (Acq.); *Sara R. Preston*, 35 B.T.A. 312 (1937) (Acq.); *Gibbs & Hudson, Inc.*, 35 B.T.A. 205 (1936) (Acq.).

2. Amounts received by a manufacturer of soft drinks from its dealers as a fund to be expended solely in a national advertising campaign, which were not expended before the close of the taxable year, were held not to be income because the funds were not received without restriction. The manufacturer was a conduit to pass the funds along to the advertising agency. The commingling of the fund with the general revenues of the manufacturer is immaterial. *Seven-Up Co., supra*. This case was followed in *Broadcast Measurement Bureau, Inc.*,

supra, where the court held that subscription fees to the Bureau to finance broadcasting studies were not received under a claim of right and without restriction as to their disposition, despite the fact that there was no definite, unconditional obligation on the Bureau to refund any of the fees at the end of the fiscal year since the study was not closed.

3. Where a contract of sale provides for withholding or deposit of part of the consideration as a guarantee of the seller's representations and such amount is not to be released until a subsequent year, the amount withheld or deposited is *not* to be included in the seller's income in the year of the sale. *Preston R. Bassett*, 33 B.T.A. 182 (1935), *aff'd* without opinion, 90 F. 2d 1004 (2nd Cir., 1937); *Comm'r* v. *Cleveland Trinidad Paving Co.*, 62 F. 2d 85 (6th Cir., 1932); *Stoner* v. *Comm'r*, 79 F. 2d 75 (3rd Cir., 1935), *cert. denied* 296 U.S. 650. In the *Stoner* case stock of a water company was sold under an agreement whereby the seller agreed to deduct from the purchase price $50,000 and to deposit said sum in a bank of the seller's choosing in an account to be known as an "Indemnity Account" for two years, the fund to be used to pay unknown liabilities of the water company which might be disclosed after the sale. In fact no such liabilities arose and the entire $50,000 was paid to the seller at the end of the two years. The court held that the income tax law was concerned only with *realized gains* and that the $50,000 was not realized gain until the end of the two-year period. The taxpayer had only qualified possession and control of the fund until then.

4. Deposits with the seller by the purchaser on contracts to purchase property which are conditional and subject to being nullified by an adverse finding of title or inability to deliver possession are not income in the year received but in the subsequent year when the transaction is closed despite the fact that the seller has physical control of the money in the earlier year. *Veenstra & De Haan Coal Co.*, 11 T.C. 964 (1948) (Acq.); *Baird* v. *United States*, 65 F. 2d 911 (5th Cir., 1935), *cert. denied* 290 U.S. 690.

5. Advance rental received by the lessor to be held as security for performance by the lessee and to be applied on the last rental payment if not otherwise used, is not income of the lessor in the year of receipt despite physical possession of the money by the lessor in that year. "* * * though the money is rightfully received, and if the parties so intend may be freely used, yet because of the acknowledged liability to account for it, there is no gain; just as in borrowing there is none." *Clinton Hotel Realty Corp.* v. *Comm'r*, 128 F. 2d 968, 969 (5th Cir., 1942). A similar result was reached in *Warren Service Corp.* v. *Comm'r*, 110 F. 2d 723 (2nd Cir., 1940), where $125,000 was deposited with a lessor in 1926 as security for the lessee's performance, with an obligation of the lessor to repay it in 1941 unless there had been a default in the meantime.

6. Unclaimed deposits and overpayment for gas by former customers were income when credited to surplus and made so available to the general use of the corporation and not in the year received from

the customers. *Boston Consol. Gas Co.* v. *Comm'r*, 128 F. 2d 473 (1st Cir., 1942). In this case the deposits and overpayments were made over a period of 30 years and carried on the books of the company as a liability, and in 1935 the company transferred the unclaimed amounts to its profit and loss (surplus) account. The court held that these amounts were income in 1935. The deposits and overpayments were in the physical control of the company from the time they were made.

7. Unclaimed deposits on cases and bottles required of customers by a beverage company became income when the balance of old deposits in the account was transferred to surplus by the company. *Wichita Coca Cola Bottling Co.* v. *United States*, 152 F. 2d 6 (5th Cir., 1945), *cert. denied* 327 U.S. 806. The deposits were credited to a special liability account. The funds deposited were in the physical control of the company from the time the deposits were made. The court held that the "financial act" of transferring the amounts in the account to "free surplus funds" created income in the year in which the act was done. In *Farmers Creamery Co.*, 14 T.C. 879 (1950) the tax court held that bottle deposits recorded in a liability account were not income to the taxpayer in the years received.

8. In *Decatur Water Supply Co.* v. *Comm'r*, 88 F. 2d 341 (7th Cir., 1937), a city created a corporation to finance an addition to its water works system. Under the corporation's charter and agreement between it and the city, 90% of the net water rents

were to be paid by the city to the corporation and used by it in paying operating expenses and the dividend on its preferred stock and retiring the preferred stock. The court held that the amounts received by the corporation from the city as water rents which were used to retire the preferred stock were not income of the corporation but a restoration of capital. From the time of the receipt of the water rents by the corporation a fund was earmarked for a single purpose—the return of capital to the preferred stockholders. The company had no freedom of disposal and the rents had no exchange value because of the restrictions attached to their receipt.

9. That portion of the selling price of cemetery lots which the corporation engaged in selling such lots is required by its sales contracts to segregate, and which it does segregate as a trust fund for the perpetual maintenance of such lots, is not taxable income. *Portland Cremation Ass'n* v. *Comm'r*, 31 F. 2d 843 (9th Cir., 1929); *Woodlawn Cemetery Association*, 28 B.T.A. 882 (1933); *American Cemetery Co.* v. *United States*, 28 F. 2d 918 (Dist. Ct. Kan., 1928). The decision of this court in *Portland Cremation Ass'n* v. *Comm'r* is of particular interest because the funds set aside were actually retained in the physical possession and control of the cemetery company and the income therefrom mingled with the general funds of the company. The maintenance fund was so free from outside constraint that the taxpayer might borrow from it at will and limit its amount at will. "While the petitioner here may be said to have had control of the money which it had

placed in the maintenance fund, diversion of that fund for corporation purposes * * * might be enjoined by a suit in equity as a violation of the trust agreement." (p. 846).

G. Decision of District Court

In its opinion the District Court below appears to have somewhat confused the two issues in this case, viz.: *first*, that the additional charges do not constitute income in 1941 and 1942 because they were not received under a claim of right and without restriction as to their disposition, and *second* that the additional charges do not constitute income in any year because they are not "income" within the meaning of the Sixteenth Amendment.

The District Court did hold that appellant received the additional charges under a claim of right (R. 97), a conclusion which we believe is not supported by the record (argument, pp. 20-21, *supra*). However, the District Court apparently took no cognizance of the additional requirement laid down by the Supreme Court in *North American Oil Consolidated* v. *Burnet*, *supra*, viz., that earnings must be received *without restriction* as to their disposition in order to be taxable income. The presence of a restriction, in the form of a binding order of the regulatory commission to segregate and hold the additional charges in subaccount 175.2, is the principal reason advanced by appellant to support its contention that the additional charges were not income in 1941 and 1942.

The authorities cited by the District Court are as follows:

North American Oil Consolidated v. *Burnet, supra.* We agree with the rule announced in this case and point out that there was no restriction whatever on the disposition of the disputed earnings paid over to the company in 1917—the company could have used this money to pay dividends or for any other purpose.

Comm'r v. *Wilcox,* 327 U.S. 404, 408, 66 S. Ct. 546 (1946). This case merely holds that an embezzler does not receive money he embezzles under a "claim of right" and therefore does not have taxable income therefrom under the rule of *North American Oil Consolidated* v. *Burnet, supra.*

United States v. *Lewis,* 340 U.S. 590, 591, 71 S. Ct. 522 (1951). This case also affirms the rule of *North American Oil Consolidated* v. *Burnet* and holds that a taxpayer who receives an excessive bonus ($22,000) under the mistaken idea that he was entitled to it, must treat it as income in the year received even though he had to return it in a subsequent year. However, the court found that the taxpayer had in the year of receipt "at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though 'mistaken' belief that he was entitled to the whole bonus". (591) Since there was no *restriction* on the use or disposition of the money which had been received under a claim of right it is obvious that it was income in the year received under *North American Oil Consolidated* v.

Burnet. The presence of a claim of right and the complete absence of a restriction on use distinguish this case from ours.

Comm'r v. *Brooklyn Union Gas Co.*, 62 F. 2d 505, 506 (2nd Cir., 1933). A gas company and five wholly-owned subsidiaries engaged in rate litigation obtained an interlocutory order from the court staying execution of reduced rates ordered by New York Public Service Commission in 1916 and directing that monies collected in excess of the reduced rates be impounded in a bank. In 1919 the excess monies so impounded in Rate Cases No. 1 were withdrawn by the companies, pursuant to court order, upon the giving of a bond for repayment to the bank in the event that the reduced rates should finally be sustained. (The "bond" was merely a bond of each of the subsidiary companies with the parent company as "surety"—see findings of facts in the opinion in this case by the Board of Tax Appeals, 22 B.T.A. 507, 510.) The purpose of the withdrawal order was to enable the company to "obtain and use" the monies deposited during the pendency of the proceeding. In 1922 the Public Service Commission retroactively abrogated its orders reducing the rates. The Commissioner attempted to tax the impounded monies as income in 1922. The companies contended the monies were income when earned—that is, when it furnished the gas. The Board held the Commissioner was in error and that the excess monies represented income properly accruable in the years in which the service was rendered and the charges

made therefor. 22 B.T.A. 507, 526. In a somewhat confusing opinion, the Court of Appeals of the Second Circuit affirmed the order of the Board, although the court thought that under the rule of *North American Oil Consolidated* v. *Burnet* the excess monies were not income in the years earned but rather in 1919, the year they were released from impoundment. The rationale of this decision would tend to support our contention that the increased installation and new supersedure charges were not income when the installations and supersedures were made (1941 and 1942) but rather when the Commission removed the restriction on their use and disposition and in effect released them from impoundment in subaccount 175.2. The court thought that the excess money was income in the year it was released from impoundment because in that year it was "received by the companies without restriction upon its use" (506). The contingent liability to repay "imposed no restriction upon their use of the money actually in their hands" (506). The fact that the companies had to give their own bonds to get the money did not add anything to the contingent liability they were under regardless of such bonds (506). This holding appears to conform to *North American Oil Consolidated* v. *Burnet.* The requirement that each company must give its own bond with its parent as surety is not a "restriction" on use because it subjected the company to no liability it was not under anyway. The company was not forbidden to pass the excess money on to its stockholders or required to keep an equivalent

amount of cash or securities on hand to repay the bank.

Gilken Corporation v. *Comm'r*, 176 F. 2d 141, 145 (6th Cir., 1949) held that money received by a lessor from its lessee as advance rental, as security for performance, and as part payment of the purchase price should the lessee exercise its option to buy, was income to the lessor when received even though he might subsequently have to return its equivalent, *because* the money had been paid over without any restriction on its use. "The taxpayer was not required to hold the money in trust, or to put it apart as a separate fund in any manner whatsoever" (144). "Here, the taxpayer had the free and unrestricted use, enjoyment and disposition of the advance rental payments during the taxable years in which received * * *" (145). This case is clearly within the rule of *North American Oil Consolidated* v. *Burnet* and clearly distinguishable from the case at bar where there is a substantial restriction imposed by the regulatory authority. Indeed we would consider that the Court of Appeals of the Sixth Circuit would be bound by the principles announced in the *Gilken* case to decide the case at bar in favor of appellant because of the presence of the restriction on use in 1941 and 1942.

Weiss v. *Wiener*, 279 U.S. 333, 335, 49 S. Ct. 337 (1929) is cited by the District Court for a general statement of Mr. Justice Holmes that the income tax laws do not profess to embody perfect economic theory. The case holds that a lessee is not entitled

to a deduction for estimated obsolescence of buildings where he had made no expenditure on this account. The case does not deal with the question of whether receipt of money under a restriction as to its disposition constitutes income.

Helvering v. *Midland Mut. L. Ins. Co.*, 300 U.S. 216, 225, 57 S. Ct. 423 (1937) is presumably cited as confirming the general statement in *Weiss* v. *Wiener, supra.* The case held that a mortgagee which bids in successfully at a foreclosure sale for the principal of its loan plus interest, received "income" to the extent of the interest. The case has no relation to questions at issue in the case at bar.

Comm'r v. *Union Pac. R. Co.*, 86 F. 2d 637, 639 (2nd Cir., 1936) held that a taxpayer on the accrual basis is taxable on the gain from land sold on an installment contract in the year the contract was made rather than in the years when the payments are made. Again, this issue is different from that in the case at bar.

Board v. *Comm'r*, 51 F. 2d 73, 75 (6th Cir., 1931). This case held that a director of a corporation, who received in 1920 $18,130.66 as his share of profits from a pipe line he constructed and sold to the corporation, was required to report such sum as taxable income in that year despite the fact that his claim to the money was perhaps illegal because of his position as director (stockholders filed action to recover the money) and he might have to return it. (In 1927 a compromise was reached whereby he was able to retain the money.) It is obvious from the facts that

there was no *restriction* whatever on the taxpayer's use or disposition of the money in 1920. Although this case preceded *North American Oil Consolidated* v. *Burnet*, the result is consistent with it because of the absence of a restriction in both cases. The Court of Appeals of the Sixth Circuit now recognizes that the absence of a restriction is a determinative factor in deciding whether "income" has been received (*Gilken Corporation* v. *Comm'r*, *supra*).

Penn v. *Robertson*, 115 F. 2d 167, 175 (4th Cir., 1940) held that where a New Jersey corporation had sold stock to a director in 1929 under a stock allotment plan not approved by the stockholders which provided for the application of dividends from the stock and credits from an employees' bonus on the purchase price, amount so applied in 1930 was income in that year notwithstanding that the plan was void (not having been approved by the stockholders) and was rescinded in 1931. The court held that the money had been constructively received by the taxpayer in 1930 under a claim of right *and without restriction* (he could have paid the portion of his note not covered by the dividends and bonus and taken up the stock at any time—pp. 174, 175). Thus, this was another case when money was received *without restriction* and is clearly distinguishable from the case at bar.

H. Annual Accounting

We concede that the requirements of the federal fisc require annual tax returns and accounting

(*Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 51 S. Ct. 150 (1931); *Security Flour Mills Co.* v. *Comm'r*, 321 U.S. 281, 64 S. Ct. 596 (1944); *Penn* v. *Robertson, supra*) so that income must be determined at the close of the fiscal year without regard to the effect of subsequent events. However, we point out that if at the close of the fiscal year the money is held *subject to a restriction* and not subject to the taxpayer's *unfettered command* or *freedom to use it at his option*, the money is not "income" for that year under the annual system of accounting or any other (*North American Oil Consolidated* v. *Burnet, supra; Corliss v. Bowers, supra; Rutkin* v. *United States, supra*). In the case at bar, at the close of the fiscal years 1941 and 1942 appellant held the additional charges subject to the restriction that it could not use them for any purpose whatever—that is, as a regulated utility company it had to have on hand at all times an equivalent amount available to be paid out for any purpose the Commission might direct. What happened subsequent to the close of the fiscal year is of no significance in determining the taxable status of the additional charges in 1941 and 1942 (*Penn* v. *Robertson, supra* at 175).

II. THE INCREASED INSTALLATION AND NEW SUPERSEDURE CHARGES ARE NOT TAXABLE INCOME TO APPELLANT IN 1941 AND 1942, OR IN ANY OTHER YEARS, BECAUSE THEY DO NOT CONSTITUTE "INCOME" WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

This is an alternative argument to that advanced in Section I—that is, if the additional charges are not to be considered as sums received by appellant subject to a restriction and thus not includable in its taxable income in the years received, such additional charges should be considered as similar to contributions by subscribers for line extensions and thus not includable in taxable income at all.

The Sixteenth Amendment provides that the Congress shall have power to lay and collect taxes on "incomes" from whatever source derived. The power of the Congress to tax is limited by the Sixteenth Amendment and the Congress cannot tax as income what in fact is not income. *Eisner* v. *Macomber*, 252 U.S. 189, 40 S. Ct. 189 (1920).

In the well-known case of *Edwards* v. *Cuba Railroad*, 268 U.S. 628, 45 S. Ct. 614 (1925), the Supreme Court held that a subsidy granted to the railroad by the Cuban government ($6,000 per kilometer of road built) did not constitute "income" within the meaning of the Sixteenth Amendment. This case was followed by the Board of Tax Appeals in determining that payments made by customers to a utility to secure line extensions to their property, do not constitute income to the utility. This re-

sult follows whether the customers erect the line and give it to the utility, or the utility erects it and is compensated for its cost by the customers. This rule has been uniformly established for many years and the Bureau of Internal Revenue has acquiesced in these decisions. See *Liberty Light & Power Co.*, 4 B.T.A. 155 (1926) (Acq.); *Rio Electric Co.*, 9 B.T.A. 1332 (1928) (Acq.); *Wisconsin Hydro-Electric Co.*, 10 B.T.A. 933 (1928) (Acq.); *Tampa Electric Co.*, 12 B.T.A. 1002 (1928) (Acq.). See also G.C.M. 1581; CB VI-1, 197.

Similarly, the courts and the Board of Tax Appeals have consistently held that contributions to a railroad company for the construction of side and spur tracks, or for other construction work, are not taxable income. *Great Northern Railway Co.*, 8 B.T.A. 225, 271 (1927) (Acq.) *aff'd* 40 F. 2d 372; *Texas & P. Ry. Co.* v. *United States*, 52 F. 2d 1040 (Ct. Cl., 1931); *Texas & Pacific Railway Co.*, 9 B.T.A. 365 (1927) (Nonacq.); *Atlantic Coast Line Railroad Co.*, 9 B.T.A. 1193 (1928) (Nonacq.); *Kansas City Southern Railway Co., et al.*, 16 B.T.A. 665 (1929); *Midland Valley Railroad Co.*, 19 B.T.A. 423 (1930); *Kansas City Southern Ry. Co., et al.*, 22 B.T.A. 949 (1931); *Union Pacific R.R.*, 26 B.T.A. 1126 (1932) (Acq.); *Southern Railway Co.*, 27 B.T.A. 673 (1933) (Acq.); *Baltimore & Ohio Railroad Co.*, 30 B.T.A. 194, 199 (1934) (Acq.). Also, the cost of construction, by a railroad, of warehouses erected on its right of way, for which it was reimbursed by shippers, is not taxable income to the rail-

road. *Kauai Railway Co., Ltd., et al.*, 13 B.T.A. 686 (1928) (Acq.).

Similarly contributions by community groups to induce new industries to settle in their districts are not income. *Aransas Compress Co.*, 8 B.T.A. 155 (1927) (Acq.); *Frank Holton & Co.*, 10 B.T.A. 1317 (1928) (Acq.). See G.C.M. 16,952; CB 1937-1,133.

Although the question of the inclusion of the contributions in income was not directly at issue, two recent Supreme Court cases support the rule of *Edwards* v. *Cuba Railroad* and the cases following it. In *Detroit Edison Co.* v. *Comm'r*, 319 U.S. 98, 63 S. Ct. 902 (1943), it was held that the cost of extensions of electric transmission lines, paid for by customers, was not includable in the basis for depreciation as taxpayer had no "cost" for such property. The taxpayer had not appropriated or earmarked the customers' contributions for the particular construction for which it was reimbursed, but such contributions went into the taxpayer's general working funds. During the period that a payment was subject to refund, it was carried in a suspense account, but if not subject to refund, or when the refund period was past, the balance was transferred to surplus (p. 100). The court said, "The receipts have gone, so far as here involved, to add to the Company's surplus. They have not been taxed as income, presumably because it has been thought to be precluded by this Court's decisions in *Edwards* v. *Cuba R. Co.*, * * *." (p. 103) Montgomery states with respect to this case: "This decision would

seem to imply acceptance of the 'no income' rule as applied in the cases cited in the preceding paragraph". [*Edwards* v. *Cuba Railroad Co.*, and line extension and spur track cases.] I Montgomery's *Federal Taxes, Corporations and Partnerships* 1951-52, p. 23.

In *Brown Shoe Co.* v. *Comm'r*, 339 U.S. 583, 70 S. Ct. 820 (1950), the court held that buildings and cash contributed by community groups in order to induce a corporation to locate its plants in their communities may properly be considered contributions to capital in determining the taxpayer's excess profits tax computed by the invested capital method. Montgomery, *supra*, states that this decision "also supports the principle that no income is realized on the receipt of such contributions". (p. 23) In this case the cash sums received by the taxpayer from the community groups were not earmarked for, or held intact and applied against, the plant acquisitions in the respective communities but were deposited in the taxpayer's general bank account from which were paid general operating expenses and the cost of all assets acquired. The cash payments were debited to cash account on the assets side of the taxpayer's ledger and were credited to earned surplus either upon receipt or after having first been assigned to contributed surplus. The values of the buildings acquired were set up in the building account on the assets side and were credited to surplus. "Both courts below and the Commissioner have expressly assumed, as petitioner asserts, that the re-

ceipts of property and cash were not taxed as income." (p. 587 and n. 5)

Appellant contends that the increased installation and new supersedure charges are similar to the afore-mentioned government subsidies or donations and to the contributions by utility subscribers or shippers for line extensions or spurs, none of which are "income". In all of these cases and in the case at bar the taxpayer acquired money or property without cost to it. The close affinity of the additional installation and supersedure charges to subscribers' contributions for line extensions is illustrated by the fact that the Commission ordered that the additional charges be credited to account No. 175, "Contributions to Telephone Plant" (R. 51), which is the account used by appellant to record subscribers' contributions for line extensions (R. 23). Subscribers' contributions for line extensions have never been reported or taxed as income (R. 23).

In order to secure the additional charges appellant had to perform certain services in connecting and reconnecting instruments and changing telephone numbers. However, it had to perform this work as part of its regular service in any event and the extra revenue was in the nature of a "windfall" to it—that is, with the exception of the billing and accounting necessary to keep the additional charges segregated, appellant did exactly the same work for subscribers in making connections and supersedures as it had done before the new charges were established and as it did after they were terminated

(R. 26-27). A "windfall" which does not cost the taxpayer anything is not "income". *Central R. Co.* v. *Comm'r*, 79 F.2d 697 (3rd Cir., 1935).

In any case, the fact that the taxpayer must expend capital and labor to become entitled to the subsidy or contribution does not mean that the subsidy or contribution is "income". In *Edwards* v. *Cuba Railroad*, *supra*, the taxpayer had to build the railroad line by use of its capital and labor before it became entitled to the subsidy, and in many of the line extension and spur track cases cited above the taxpayer had to expend capital and use labor to build the line or spur before it became entitled to the contribution.

The fact that appellant's subscribers may have had no "intent" to make a contribution or donation to it is immaterial—there cannot have been any intent on the part of the subscribers or shippers in the line extension and spur line cases, *supra*, to make a contribution or donation to the utility. This point was urged by the dissenting judge in the first of the line extension cases (*Liberty Light & Power Co.*, *supra*, p. 164) but was not accepted by the majority and the Commissioner has long since acquiesced in the decision (CB, VI-1,4). Similarly, the fact that the additional charges came from appellant's usual source of income (its subscribers) and in the performance of one of its normal business functions is not significant since the same was true in the line extension and spur line cases, as pointed

out by the dissenting judge in *Liberty Light & Power Co.*

It is not necessary that the additional charges be treated as part of appellant's invested capital in order to come within the rule of the above cases. In *Tampa Electric Co., supra,* the Board reaffirmed its holding on the same point in *Frank Holton & Co., supra,* and decided that subscribers' contributions for line extensions could *not* be treated by the utility as part of its invested capital (12 B.T.A. 1002, 1006). Also, it is not necessary that the additional charges be earmarked for or applied specifically against capital improvements. In *Edwards* v. *Cuba Railroad, supra,* the facts were that the subsidy payment was transferred to the company's *surplus account* (p. 630), and although it was used for capital expenditures it need not have been. It could have been used to pay dividends or for any other purpose. In *Detroit Edison Co., supra,* the utility had not appropriated or earmarked the contributions for capital improvements and the contributions merely went into its general working funds and were finally transferred to surplus. In *Brown Shoe Co., supra,* the cash received was not earmarked for capital items but went into the general bank account and eventually to earned surplus.

The opinion of the District Court below does not deal clearly with this argument that the additional charges are not "income" under the Sixteenth Amendment. The court merely states that the language of the Amendment itself and of the Internal

Revenue Code refute this contention and that the holdings of the Supreme Court negative its validity (R. 96). The cases cited all deal with the "claim of right" doctrine and not with the question of whether subsidies, donations and contributions are "income". *Edwards* v. *Cuba Railroad* holds that under the language of the Sixteenth Amendment a government subsidy is not "income", and the courts and Board of Tax Appeals and the Commissioner have followed this holding for many years and applied it to subscribers' contributions for line extensions and spur tracks. We consider that the additional charges are in all material respects the same as subscribers' contributions for line extensions and should be given the same income tax treatment.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the increased installation and new supersedure charges were *not* taxable income to appellant in 1941 and 1942 and that the judgment of dismissal entered by the District Court below should be reversed and that court directed to enter judgment for appellant accordingly.

Respectfully submitted,

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May 20, 1952